

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements

June 30, 2005

(1) Summary of Significant Accounting Policies

The City of Annapolis (City) is an incorporated municipality governed by a mayor and eight aldermen who together constitute the City Council. The City government provides most basic local governmental services except education, which is provided through the Anne Arundel County Board of Education.

For financial reporting purposes, the basic financial statements include the various departments governed directly by the City Council. The City does not have any component units as defined by accounting principles generally accepted in the United States of America (GAAP). A component unit is defined as a separate legal entity that a primary government must include as part of its financial reporting entity for fair presentation in conformity with GAAP. The Mayor is responsible for appointing the commissioners of the Annapolis Public Housing Authority, but the City's accountability for this organization does not extend beyond making the appointment.

The accounting policies of the City conform to GAAP as applicable to governmental units. The following is a summary of the more significant policies:

(A) Basis of Presentation - Fund Accounting

The accounting system is organized and operated on a fund basis. A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations.

The City's funds are grouped into two broad fund categories and five generic fund types for financial statement presentation purposes. Governmental funds include the general, special revenue and capital projects funds. Proprietary funds include enterprise funds and an internal service fund. The City has one fiduciary fund which is comprised of a pension trust fund.

The basic financial statements include certain prior-year summarized comparative information in total but not at the level of detail required for a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the government's financial statements for the year ended June 30, 2004, from which the summarized information was derived.

(B) Basis of Accounting

GOVERNMENT-WIDE FINANCIAL STATEMENTS

The government-wide financial statements (i.e., the Statement of Net Assets and the Statement of Activities) report information on all non-fiduciary activities of the primary government. Governmental activities, which normally are supported by taxes and intergovernmental revenues, are reported separately from business-type activities, which primarily rely on fees and charges for support. Internal service fund activity is eliminated to avoid "doubling up" revenues and expenses. Fiduciary funds are excluded from the government-wide financial statements.

The government-wide statements are prepared using the economic resources measurement focus and the

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(1) Summary of Significant Accounting Policies, Continued

accrual basis of accounting. This is the same approach used in the preparation of the propriety fund financial statements but differs from the manner in which governmental fund financial statements are prepared. Therefore, governmental fund financial statements include reconciliations with brief explanations to better identify the relationship between the government-wide statements and the statements for governmental funds. The primary effect of internal activity has been eliminated from the government-wide financial statements.

The government-wide Statement of Activities presents a comparison between expenses, both direct and indirect, and program revenues for each segment of the business-type activities of the City and for each governmental program. Direct expenses are those that are specifically associated with a service, program or department and are therefore clearly identifiable to a particular function. Indirect expenses for centralized services and administrative overhead are allocated among the programs, functions and segments using a full cost allocation approach and are presented separately to enhance comparability of direct expenses between governments that allocate direct expenses and those that do not. Program revenues include charges paid by the recipients of the goods or services offered by the programs and grants and contributions that are restricted to meeting the operational or capital requirements of a particular program. Revenues not classified as programs revenues are presented as general revenues. The comparison of program revenues and expenses identifies the extent to which each program or business segment is self-financing or draws from the revenues of the City.

Net assets should be reported as restricted when constraints placed on net asset use are either externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or imposed by laws through constitutional provisions or enabling legislation. The net assets restricted for other purposes result from special revenue funds and the restrictions on their net asset use.

Separate financial statements are provided for governmental funds, propriety funds, and fiduciary funds, even though the latter are excluded from the government-wide financial statements. Major individual governmental funds and major individual enterprise funds are reported as separate columns in the fund financial statements.

FUND FINANCIAL STATEMENTS

Fund financial statements report detailed information about the City. The focus of governmental and enterprise fund financial statements is on major funds rather than reporting funds by type. Each major fund is presented in a separate column. Non-major funds are aggregated and presented in a single column except for the special revenue fund which is presented in a separate column. The internal service fund is presented in a single column on the face of the propriety fund statements.

GOVERNMENTAL FUNDS

All governmental funds are accounted for using modified accrual basis of accounting and the current financial resources measurement focus. Under this basis revenues are recognized in the accounting period in which they become measurable and available. The City considers revenues to be available if they are collected within sixty days of the end of the current year. Expenditures are recognized in the accounting period in which the fund liability is incurred, if measurable.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(1) Summary of Significant Accounting Policies, Continued

The major governmental funds are:

General Fund - This is the City's primary operating fund. It is used to account for all financial resources except those required to be accounted for in another fund.

Capital Projects Fund - The Capital Projects Fund is used to account for financial resources and expenditures applied to the construction of capital facilities and major purchased items for all governmental fund types.

Special Revenue Fund - The Special Revenue Fund is used to account for Community Development Block Grants received from the Federal government.

(C) Measurement Focus and Basis of Accounting

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and current liabilities generally are included on the balance sheet. Operating statements of these funds present increases (i.e. revenues and other financing sources) and decreases (i.e. expenditures and other financing uses) in net current assets. The unreserved fund balance is a measure of available spendable resources.

The modified accrual basis of accounting is followed by the governmental funds. Under this basis, revenues are recorded when susceptible to accrual, i.e., both measurable and available. Available means collectible within the current period or soon enough thereafter, within sixty days of the end of the current year, to be used to pay liabilities of the current period. Expenditures are recorded for decreases in net financial resources when a fund liability is incurred, if measurable, except for debt service, which is recognized when due.

Property taxes levied during the current year are recorded as receivables and deferred revenue, net of estimated uncollectible amounts. The net receivables collected during the current year and within sixty days after year end are recognized as revenues in the current year.

Income taxes, highway user fees, hotel / motel taxes, admission taxes and rent payments are all major revenue sources susceptible to accrual and so have been recognized as revenues in the current year.

Licenses and permits, charges for non-enterprise services, fines and forfeitures and miscellaneous revenues (except investment earnings) are recorded as revenues when received in cash because they are generally not measurable until actually received. Investment earnings are recorded as earned since they are measurable and available.

In applying the susceptible to accrual concept to intergovernmental revenues, the legal and contractual requirements of the numerous individual programs are used as guidance. There are, however, essentially two types of these revenues. In one, monies must be expended on the specific purpose or project before any amounts will be paid to the City; therefore, revenues are recognized based upon the expenditures recorded. In the other, monies are virtually unrestricted as to purpose of expenditure and are usually revocable only for failure to comply with prescribed compliance requirements. These

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(1) Summary of Significant Accounting Policies, Continued

resources are reflected as revenues at the time of receipt or earlier if the susceptible to accrual criteria are met.

PROPRIETARY FUNDS

All propriety funds are accounted for using the accrual basis of accounting. The accrual basis of accounting recognizes revenues when they are earned and expenses when liabilities are incurred. These funds account for operations that are primarily financed by user charges. All propriety funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation of these funds are included on the balance sheet. Net assets (i.e., net total assets) are segregated into invested in capital assets, net of related debt, restricted and unrestricted. Propriety funds operating statements present increases (e.g., revenues) and decreases (e.g., expenses) in net assets. In accordance with GASB Statement No. 20, "Accounting and Financial Reporting for Propriety Funds and other Governmental Entities that use Propriety Fund Accounting," the City has elected not to follow any pronouncements issued by the Financial Accounting Standards Board since November 30, 1989.

Propriety funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and delivering goods in connection with a propriety funds principal ongoing operations. The principal operating revenues of all the City's enterprise funds and internal service fund are charges to customers for sales and services. Operating expenses for enterprise funds and internal service funds include the cost of sales and services, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

The major propriety funds are:

Water Fund - To account for all financial activity associated with the operation of the City's water plant and water distribution system. The water plant is responsible for the production, treatment, testing, storage and initial distribution of all potable water for the customers of the City. The water distribution division is responsible for meter reading and operating, maintaining and repairing the distribution system.

Sewer Fund - To account for all financial activity associated with the operation of the City's sewage collection and treatment program. The sewer fund consists of two divisions: sewer plant and sewer collection. The sewer collection division is responsible for operating, maintaining and repairing the sewage conveyance system. Sewage treatment is performed at a single, jointly-owned plant site controlled and operated by Anne Arundel County. The City has a fifty percent ownership of the property, plant and equipment but does not have joint control of the financial or operating policies, thus the arrangement is not considered a joint venture. The current agreement calls for the City to share in actual costs for fifty percent of capital improvements and a flow-based percentage of operational costs.

Off Street Parking Fund - To account for all financial activity associated with the operations of the City's municipal off street parking facilities. The parking facilities include two parking garages and two parking lots.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(1) Summary of Significant Accounting Policies, Continued

Transportation Fund - To account for all financial activity associated with the operation and maintenance of the City's public transportation system. The transportation fund consists of three divisions:

Administration, Transit Operations and Maintenance.

The non-major propriety funds shown aggregated are:

Dock Fund - To account for all financial activity associated with the management and control of the City's waterways, including slips and mooring buoys, showers and restrooms for boaters, sewage pump-out facilities for boaters, and maintenance of the City Dock area.

Market Fund - To account for all financial activity associated with the operation of the City's Market House, an enclosed pavilion housing vendors who sell a variety of carry-out, affordable foods and beverages.

Stormwater Management Fund - To account for all financial activity associated with the maintenance of public storm drainage systems, which includes pipes, inlets, manholes, drainage ways and stormwater management facilities.

Refuse Fund - To account for all financial activity associated with the operation of the City's residential refuse, yard waste, recycling and bulk disposal systems. The refuse fund consists of three divisions: Residential Refuse, Yard Waste Recycling and Curbside Recycling.

The City's only Internal Service Fund is used to account for the activities of a self-insurance program for general and automotive liability claims. The liability for unpaid claims, which is included in other liabilities, is based upon individual case estimates reported as of June 30, 2005 and management's estimate of claims incurred but not reported to that date.

When both restricted and unrestricted resources are available for use, it is the government's policy to use restricted resources first, and then unrestricted resources as they are needed.

FIDUCIARY FUND - PENSION TRUST FUND

The City currently has one fiduciary fund. The Pension Trust Fund is used to account for pension assets held by the City in a trustee capacity. This fund is accounted for and reported in a manner similar to proprietary funds since capital maintenance is critical.

(D) Implementation of New Accounting Principles

The City adopted the provisions of Governmental Accounting Standards Board Statement No. 40, "Deposit and Investment Risk Disclosures - an amendment of GASB Statement No. 3". This Statement addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. Disclosure of investment categories (as required by GASB Statement No. 3) has been eliminated. Adoption of the standard has no material impact on the City's financial statements.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(1) Summary of Significant Accounting Policies, Continued

The Governmental Accounting Standards Board issued Statements No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, No. 46, *Net Assets Restricted by Enabling Legislation - an amendment of GASB Statement No. 34*, and No. 47, *Accounting for Termination Benefits* which become effective July 1, 2005, July 1, 2006, July 1, 2005 and July 1, 2007, respectively. The City is analyzing the effects of pronouncements and plan to adopt them by the effective dates.

(E) Budgetary Process

The City follows these procedures in establishing its budgetary data for the General Fund, Capital Projects Fund, and Enterprise Funds.

- (1) By the second Monday in April, the Mayor submits to the City Council a proposed budget for the General Fund and each of the enterprise funds for the fiscal year commencing the following July 1.
- (2) The budget is referred to the Finance Committee, which makes recommendations on the budget to the full City Council by the second Monday in May.
- (3) The City Council holds public hearings to obtain taxpayer comments.
- (4) No later than June 30, the budget is legally enacted through passage of a budget ordinance which establishes spending authority by fund for the operations of the City.
- (5) Supplemental appropriations and transfers between funds must be approved by the City Council. The allocation of funds from the surplus of the budget requires a two-thirds vote by the City Council.

All budgets are on an annual basis except the Capital Projects Fund budget which is on a project basis. Budgets are adopted using the same basis of accounting as used for reporting purposes, except that for governmental funds, encumbrances are treated as expenditures. Unencumbered appropriations lapse at June 30 for all funds, except the Capital Projects Fund.

(F) Investments

Short-term investments of the City are recorded at fair value. Investments in the Pension Trust Fund represent the pension plan's ownership interests in the net assets of various investment funds.

The investments in these funds are recorded at fair value.

(G) Inventories and Prepaid Items

Inventories consist of supplies and materials valued at cost using the first-in/first-out method and prepaid items consists of insurance premiums, collection services and bulk permit for postage valued at cost using the consumption method. They are recorded as expenditures/expenses as

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Notes to Basic Financial Statements, Continued

(1) Summary of Significant Accounting Policies, Continued

the items are used.

(H) Capital Assets and Depreciation

The accounting and reporting treatment applied to the capital assets associated with a fund are determined by its measurement focus. General capital assets are long-lived assets of the City as a whole. When purchased, such assets are recorded as expenditures in the governmental funds and capitalized. Infrastructure such as streets, traffic signals and signs are capitalized. The valuation bases for general capital assets are historical cost, or where historical cost is not available, estimated historical cost based on replacement cost. The minimum capitalization threshold is any individual item with a total cost greater than \$5,000 and a useful life of more than one year.

Capital assets in the propriety funds are capitalized in the fund in which they are utilized. The valuation bases for propriety fund capital assets are the same as those used for the general capital assets. Donated capital assets are capitalized at estimated fair market value on the date donated.

Depreciation of capital assets is computed and recorded by the straight-line method. Estimated useful lives of the various classes of depreciable capital assets are as follows: building, 20 to 50 years; improvement/infrastructure, 5 to 50 years; and equipment, 2 to 15 years.

(I) Vacation and Sick Leave

Vacation benefits are earned by employees of the City based on time in service, and the rights to such benefits are vested. Sick leave is also accumulated by employees based on time in service. Accumulated sick leave benefits do not vest and are not paid unless sickness causes employees to be absent; however, accumulated sick time not used is credited to months of service in the calculation of employees' retirement benefits.

The City records vested vacation benefits as earned. The amount earned and unused is recorded as a liability in the respective funds since the City estimates that the entire amount is current. In accordance with GASB Statement Number 16, "Accounting for Compensated Absences," the City also recorded the related social security and medicare taxes as a liability as of June 30, 2005.

(J) Cash and Cash Equivalents

For purposes of the statement of cash flows, highly liquid investments with a maturity of three months or less when purchased are considered to be cash equivalents.

(K) Designations of Fund Balance

Designations of fund balance represent tentative management plans that are subject to change. If a fund establishes a negative fund balance then the City may elect to subsidize that fund. The City plans to fund the net asset deficit in the Transportation fund by controlling costs and transferring resources from the Off Street Parking fund.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(1) Summary of Significant Accounting Policies, Continued

(L) Reclassifications

Certain amounts on the 2004 financial statements have been reclassified to conform with current year presentations.

(2) Differences Between GAAP and Budget Basis

The basic financial statements and notes conform with GAAP, which provides that the Statement of Revenues and Expenditures and Encumbrances - Budget and Actual - General Fund (Budget Basis) should be prepared on a budget basis for the governmental funds that are budgeted annually. The statement is also designed to demonstrate compliance and non-compliance with budget limitations. In the General Fund, the budget basis differs from GAAP in that the budget basis reflects encumbrances as the equivalent of expenditures. GAAP reflects encumbrances only as reservations of fund balance. Also, interfund transfers are considered as the equivalent of revenues and expenditures of the affected funds under the budget basis. In addition, new capital leases are recorded as an expenditure and as an other financing source only on a GAAP basis.

(3) Property Tax

The City's real property tax is levied each July 1 on the assessed values certified as of that date for all taxable real property located in the City. At that time, a lien is placed against the property. Assessed values are established by the Maryland State Department of Assessments and Taxation at predetermined percentages of estimated market value. A revaluation of all property is required to be completed every three years. Payments are due by September 30. Beginning October 1, interest is charged each month or fraction thereof until such taxes are paid. Delinquent taxes are collected, after the ninth month of delinquency, by tax sales conducted by Anne Arundel County. The assessed market value of taxable real property and personal property as of July 1, 2004 was approximately \$3,566,024,862 and \$143,047,160, respectively.

(4) Deposits and Investments

The City maintains an investment pool that is available to all funds except the Pension Trust Fund, which holds investments separate from other City funds and controls its own cash transactions. All other City cash receipt and disbursement transactions are initiated in the General Fund and amounts applicable to other funds are transferred through the respective interfund receivable and payable accounts. The cash balance of the Internal Service Fund is maintained in a separate account at the Maryland Local Government Investment Pool.

(A) City's Cash and Investments

Custodial Credit Risk - Deposits: In the case of deposits, this is the risk that in the event of a bank failure, the government's deposits may not be returned to it. The City's investment policy requires at least 102 % collateralization of deposits. The carrying amount of total deposits, for the City was (\$685,118) and the bank balance was \$628,304 at June 30, 2005. The City had initiated a transfer of funds to cover the negative deposits as of June 30, 2005. The bank balance was covered by federal depository insurance or by collateral held by the City's agent in the City's name.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(4) Deposits and Investments, Continued

Investments: The City is authorized to invest in obligations of the U. S. Treasury, agencies and instrumentalities, bankers' acceptances, repurchase agreements, certificates of deposit, and the state's local government investment pool.

Interest Rate Risk: The City plans its investments to match cash flow requirements. Generally, the City does not directly invest in securities maturing more than one year from the date of purchase. The Maryland Local Government Investment Pool used by the City is operated in accordance with Rule 2a7 of the Investment Company Act of 1940. The City's investments in the pool is not included in the computation of weighted average maturity.

Credit Risk: State law limits investments in bankers' acceptances and commercial paper to the highest letter and numerical rating by at least one nationally recognized statistical rating organization. The Maryland Local Government Investment Pool is rated AAAM by Standard & Poor's.

Concentration of Credit Risk: The City places no limit on the amount the City may invest in any one issuer. The City currently invests 100% in the state's local government investment pool. For more information contact the City of Annapolis, 160 Duke of Gloucester Street, Annapolis, MD 21401.

(B) Pension Trust Fund Cash and Investments

The City's Pension Trust fund, the Police & Fire Retirement Plan(the Plan) has an investment policy that is designed to provide benefits as anticipated through a carefully planned and executed investment program that achieves a reasonable long term total return consistent with the level of risk assumed. To help achieve this return, professional investment managers are employed by the Plan to manage the Plan's assets. The Plan employs State Street Bank as trustee for the assets.

Cash: At June 30, 2005, the Plan had no cash with the Plan's trustee.

Investments: Contractually, the City's investment managers are restricted to investments in common stock, public bonds, real estate and money market investment funds. The Plan's investment policy includes an asset allocation plan for investments. The target allocation is 65% equities and 35% fixed income. The minimum and maximum percentages for equities are 55% and 75%, respectively, and for fixed income are 25% and 45%, respectively.

Investments of the Plan as of June 30, 2005:

<u>Investments</u>	<u>Fair Value</u>
Common stocks	\$ 124,489,658
Money market funds	3,423,703
Fixed income	8,668,302
Real estate investment trust	4,359,986
Total	\$ <u>140,941,649</u>

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(4) Deposits and Investments, Continued

Interest rate risk: The Plan's investment policy does not place any limits on the investment managers with respect to the duration of their investments. The following list shows Plan's investments and their related weighted-average maturities:

<u>Investment Type</u>	<u>Fair Value</u>	<u>Weighted Average Maturity(in years)</u>
Corporate bonds	\$ 8,668,302	11.57
U.S. Agency securities	3,423,703	1.25
Total	<u>\$ 12,092,005</u>	
Portfolio weighted average maturity		9.86

Credit Risk: The money market fund used by State Street Bank is unrated.

Custodial Credit Risk: State Street invests in a money market fund on behalf of the Plan. At June 30, 2005, the amount in the money market fund was \$580,593. This fund is uninsured and uncollateralized. All other investments of the fund are held by State Street Bank as trustee in the Plan's name.

(5) Liability for Unpaid Claims

The accrued payables and other liabilities of the City's General fund and Internal Service fund consisted of \$1,306,891 and \$23,740, respectively for the unpaid claims liability.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(6) Capital Assets and Depreciation

Capital asset activity for the year ended June 30, 2005 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Governmental activities:				
Not being depreciated:				
Land	\$ 4,099,953	\$ -	\$ -	\$ 4,099,953
Construction in process	15,354,206	9,940,636	(17,478,761)	7,816,081
Subtotal	<u>19,454,159</u>	<u>9,940,636</u>	<u>(17,478,761)</u>	<u>11,916,034</u>
Other capital assets:				
Buildings	13,053,435	269,067	-	13,322,502
Improvements/infrastructure	36,454,546	15,239,269	(97,383)	51,596,432
Equipment	10,480,942	915,317	(703,796)	10,692,463
Subtotal	<u>59,988,923</u>	<u>16,423,653</u>	<u>(801,179)</u>	<u>75,611,397</u>
Accumulated depreciation:				
Buildings	(10,388,497)	(85,770)	-	(10,474,267)
Improvements/infrastructure	(28,745,420)	(488,043)	-	(29,233,463)
Equipment	(6,461,051)	(661,731)	600,371	(6,522,411)
Subtotal	<u>(45,594,968)</u>	<u>(1,235,544)</u>	<u>600,371</u>	<u>(46,230,141)</u>
Net capital assets	<u>\$33,848,114</u>	<u>\$25,128,745</u>	<u>(\$17,679,569)</u>	<u>\$41,297,290</u>

Depreciation was charged to functions as follows:

Governmental activities:

General government	\$ 55,238
Public safety	507,377
Community services	123,270
Public works	549,659
Total governmental activities depreciation expense	<u>\$ 1,235,544</u>

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(6) Capital Assets and Depreciation, Continued

	Beginning Balance	Increases	Decreases	Ending Balance
Business-type activities:				
Not being depreciated:				
Land	\$ 3,243,442	\$ -	\$ -	\$ 3,243,442
Construction in process	6,775,860	4,180,490	(9,261,254)	1,695,096
Subtotal	<u>10,019,302</u>	<u>4,180,490</u>	<u>(9,261,254)</u>	<u>4,938,538</u>
Other capital assets:				
Buildings	34,746,099	8,405,468	-	43,151,567
Improvements/infrastructure	25,439,115	665,885	-	26,105,000
Equipment	8,236,059	556,492	(492,743)	8,299,808
Subtotal	<u>68,421,273</u>	<u>9,627,845</u>	<u>(492,743)</u>	<u>77,556,375</u>
Accumulated depreciation:				
Buildings	(12,211,609)	(1,178,135)	-	(13,389,744)
Improvements/infrastructure	(10,653,312)	(491,974)	-	(11,145,286)
Equipment	(5,950,210)	(609,511)	287,583	(6,272,138)
Subtotal	<u>(28,815,131)</u>	<u>(2,279,620)</u>	<u>287,583</u>	<u>(30,807,168)</u>
Net capital assets	<u>\$ 49,625,444</u>	<u>\$ 11,528,715</u>	<u>\$ (9,466,414)</u>	<u>\$ 51,687,745</u>

Depreciation was charged to functions as follows:

Business-type activities:

Water	\$ 558,361
Sewer	724,985
Off street parking	414,152
Transportation	336,894
Other	245,228
Total business-type activities depreciation expense	<u>\$ 2,279,620</u>

(7) Debt

The City issues general obligation bonds to provide funds for the acquisition and construction of major capital facilities. General obligation bonds have been issued for both governmental and business-type activities. These bonds therefore are reported in the proprietary funds if they are expected to be repaid from proprietary fund revenues. In addition, general obligation bonds have been issued to refund general obligation bonds. General obligation bonds are direct obligations and pledge the full faith and credit of the City. All debt service payments are made from the General fund and expenses are then allocated to the appropriate proprietary fund. The City also participates in the Maryland Local Government Insurance Trust, a public entity risk pool, which provides insurance for claims in

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(7) Debt, Continued

excess of coverage provided by the City's self-insurance fund. In 1990, Certificates of Participation were issued by the trust with the City's share being approximately 2% of the total. All claims payments are made from the Trust's fund balance and are due annually to 2009.

Under provisions of Article 41, Section 14-101 through 14-109 of the Annotated Code of Maryland, the City has participated in Economic Development Revenue Bonds for various projects within the City. Neither the bonds, nor the interest thereon, constitute an indebtedness or contingent liability of the City and, accordingly, they are not included in the basic financial statements. During fiscal year 1998, the City issued \$7,835,000 of these bonds on behalf of St. John's College, a Maryland not-for-profit educational corporation. The aggregate amount of conduit debt outstanding as of June 30, 2005 was \$6,735,000.

In February, 2005 the City issued \$25,000,000 Special Obligation Bonds for the Park Place Project, a mixed use development. This debt does not appear in the City's basic financial statements as this debt does not constitute an indebtedness or contingent liability of the City. The bonds will be repaid with tax increment revenues, net garage operating revenues, and if necessary a special tax imposed on the taxable parcels of the development.

The following is a summary of changes in long-term liabilities by type of the City for the year ended June 30, 2005:

	Beginning Balance	Additions	Reductions	Unamortized loss on refunding	Ending Balance	Amount due within one year
Governmental Activities:						
General obligation bonds	\$ 19,668,33	\$ -	\$ (1,870,191)	\$ -	\$ 17,798,144	\$ 1,733,449
Other debt	157,812.	-	(157,812)	-	-	-
Compensated absences	1,792,643.	90,689	(27,488)	-	1,855,844	-
	<u>\$ 21,618,79</u>	<u>\$ 90,689</u>	<u>\$ (2,055,491)</u>	<u>\$ -</u>	<u>\$ 19,653,988</u>	<u>\$ 1,733,449</u>
Business-type Activities:						
General obligation bonds	\$ 20,571,67	\$ -	\$ (1,764,810)	\$ 67,421	\$ 18,874,288	\$ 1,741,551
Other debt	999,830	-	(77,066)	-	922,764	79,571
Compensated absences	365,763	31,687	(14,383)	-	383,067	383,067
	<u>\$ 21,937,27</u>	<u>\$ 31,687</u>	<u>\$ (1,856,259)</u>	<u>\$ 67,421</u>	<u>\$ 20,180,119</u>	<u>\$ 2,204,189</u>

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(7) Debt, Continued

The City is not in violation of any debt agreement provisions. The City Charter limits the aggregate amount of bonds and other indebtedness, with certain exceptions, to 10% of the assessable base of the City, which includes real and personal property. At June 30, 2005, the debt margin of the City was as follows:

Assessable basis upon which tax levy for year beginning July 1, 2004 was calculated	\$ <u>3,709,072,022</u>
Debt limit; 10% of assessable basis	370,907,202
Debt subject to limitation	<u>27,330,628</u>
Debt margin	\$ <u><u>343,576,574</u></u>

Long-term debt amounts are comprised of the following as of June 30, 2005:

Governmental activities:

General obligation bonds:

Public Improvements and Refunding Bonds of 1994: \$3,941,632; interest 3.3% to 5.9%; due serially to 2015	\$699,123
Public Improvements and Refunding Bonds of 1998: \$9,862,595; interest 4.375% to 5%; due serially to 2017	5,285,960
Public Improvements Bonds of 2002: \$9,552,799; interest 2.5% to 5%; due serially to 2018	8,276,654
Refunding Bonds of 2003: \$3,571,236; interest 2.65% ; due serially to 2015	<u>3,536,407</u>
Total governmental activities long-term debt	<u><u>\$17,798,144</u></u>

Business-type activities:

General obligation bonds:

Public Improvements and Refunding Bonds of 1994: \$3,503,368; interest 3.6% to 5.9%; due serially to 2015	\$453,256
Public Improvements and Refunding Bonds of 1998: \$9,352,405; interest 4.375% to 5%; due serially to 2017	4,878,609
Public Improvements Bonds of 2002: \$11,332,201; interest 2.5% to 5%; due serially to 2018	9,818,346
Refunding Bonds of 2003: \$4,118,764; interest 2.65% ; due serially to 2015	3,724,077

Other debt:

State of Maryland Water Quality loan: \$1,570,795; interest 3.25% payable from net cash provided by operations of sewer as generated	<u>922,764</u>
Total business-type activities debt	<u><u>\$19,797,052</u></u>

Interest costs incurred on general obligation bonds allocated to the business-type activities were \$822,396 for the year ended June 30, 2005.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(7) Debt, Continued

Long-term debt maturities excluding the unamortized loss on refunding of \$527,567 in business-type activities are scheduled as follows:

	General obligation bonds		Other debt		Total
	Principal	Interest	Principal	Interest	
Governmental activities:					
2006	\$ 1,733,449	\$ 698,145	\$ -	\$ -	\$ 2,431,594
2007	1,822,212	617,446	-	-	2,439,658
2008	1,607,345	555,424	-	-	2,162,769
2009	1,642,537	486,347	-	-	2,128,884
2010	1,441,413	432,039	-	-	1,873,452
2011-2015	6,750,862	1,345,945	-	-	8,096,807
2016-2020	2,800,326	236,855	-	-	3,037,181
	<u>\$ 17,798,144</u>	<u>\$ 4,372,201</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 22,170,345</u>
Business-type activities					
2006	\$ 1,741,551	\$ 755,940	\$ 79,571	\$ 29,990	\$ 2,607,052
2007	1,887,788	675,369	82,157	27,404	2,672,718
2008	1,747,655	611,925	84,827	24,734	2,469,141
2009	1,782,463	536,927	87,584	21,977	2,428,951
2010	1,593,587	478,557	90,430	19,130	2,181,704
2011-2015	7,539,138	1,497,612	498,195	49,610	9,584,555
2016-2020	3,109,673	264,721	-	-	3,374,394
	<u>\$ 19,401,855</u>	<u>\$ 4,821,051</u>	<u>\$ 922,764</u>	<u>\$ 172,845</u>	<u>\$ 25,318,515</u>

(8) Pension Plans

Generally, all regular City employees, except policemen and firemen, participate in the Employees Retirement and Pension Systems (Systems), cost sharing multiple-employer defined benefit plan sponsored and administered by the State Retirement and Pension System of Maryland. Police and fire personnel participate in a single employer defined benefit pension and disability plan, which is administered by the City's personnel director. In addition, the City established an eight-member police and fire retirement plan commission to review funding and actuarial reports and to make investing decisions. The City Council has the authority to establish and amend benefit and contribution provisions. The Systems were created by the Maryland General Assembly and the Police and Fire System was established by City legislation.

Plan Description and Contribution Information

(A) Cost Sharing Multiple-Employer Plan

The Systems provide retirement, disability, and death benefits to participants and their beneficiaries. The State Retirement and Pension System of Maryland issues a publicly available financial report that includes financial statements and required supplementary information. The financial

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(8) Pension Plans, Continued

report may be obtained by writing to State Retirement Agency of Maryland, 120 East Baltimore Street, Baltimore, Maryland 21202.

Members of the Retirement System are required to contribute 5% and the City is required to contribute the remaining amount. For the participants in the Pension System, the City contributes 100%. City contributions to the Systems, which were equal to 100% of the required contribution, for the years ended June 30, 2005, 2004, and 2003 were \$938,067, \$643,647, and \$504,727, respectively.

(B) Single Employer Plan

The Police and Fire System is a single-employer defined benefit plan that covers the police and fire personnel of the City. The plan provides retirement, disability, and death benefits to its members and beneficiaries. Participants with twenty years of service and hired before August 1, 1972, or those hired between August 1, 1972 and August 1, 1979 and age 55 are eligible for benefits equal to 2% of average earnings times years of service to a maximum of thirty years but no benefits are provided for early retirement. Participants in the revised version of the plan with twenty-five years of service are eligible for benefits equal to 2% of average earnings times years of service to a maximum of thirty-seven and one-half years. Reduced benefits are available under this plan at age 50 with twenty years of service.

Participants in the original plan are required to contribute 3% of their annual salary and the revised plan participants are required to contribute 5% of their annual salary. The City is required to fund the remaining cost of the plan. The City does not calculate a net pension obligation, but develops an annual required contribution as a percent of payroll. The annual pension cost is equal to the annual required contribution. The contribution rate applied to actual payroll is actuarially determined and consists of a normal cost component and an unfunded actuarial liability component. As of July 1, 2004, the normal cost rate was 20.46% and the unfunded actuarial liability rate was a negative 28.35%. As a result of the net negative contribution rate, the City did not have an annual required contribution for the fiscal year ending June 30, 2005. The City had no annual required contribution, but made contributions of \$229,167, \$181,293, and \$271,940, for the fiscal years ending June 30, 2005, 2004, and 2003, respectively. The City has made all the required contributions. Administrative costs of the plan are financed through investment earnings. The plan is considered part of the City's reporting entity and is included in the City's financial statements as Pension Trust funds. There is no separately issued financial report for this plan.

The number of employees covered and current membership classification as of July 1, 2004 are as follows:

Non-Active Members:

Retirees and beneficiaries receiving benefits	140
Terminated employees not yet receiving benefits	29

Active Employees:

Fully vested	21
Non-vested	189

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(8) Pension Plans, Continued

Additional information as of the latest actuarial valuation follows:

Actuarial valuation date	7/1/04
Actuarial cost method	Entry age normal
Amortization method	Level dollar
Remaining amortization period	10 years - open
Asset valuation method	Asset smoothing
Actuarial assumptions:	
Investment rate of return	7.5% compounded annually
Projected salary increases	6.0% compounded annually
Cost of living adjustments	2.5% compounded annually
Inflation rate	5.0%
Contribution rates:	
City	0%
Members	3 - 5%

Historical trend information gives an indication of the progress made in accumulating sufficient assets to pay benefits when due and is presented as required supplementary information in the section which follows the "Notes to Financial Statements" section.

(9) Other Post Retirement Benefits

The City provides a post-employment health insurance program through the General Fund in addition to the pension benefits described in Note 8. These post-employment benefits are subject to change at any time. All employees who retire from the City may participate in the program. In order to be eligible, the retiree must meet normal service retirement criteria, and immediately preceding retirement, been enrolled in a medical, vision or prescription drug insurance plan offered to active employees of the City. The City will pay 80% of the retiree's health insurance premium based upon these criteria. Other retirees who do not meet the eligibility criteria are permitted to participate in the health insurance program by paying the full premium at the group rate.

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(10) Interfund Receivables, Payables and Transfers

Interfund receivables and payables, which are for temporary balances between other funds and the general fund where cash is pooled, consist of the following at June 30, 2005:

	<u>Receivables</u>	<u>Payables</u>
General Fund:		
Internal Service Fund	\$ 1,615,390	\$ -
Enterprise Funds:		
Off Street Parking Fund	4,080,618	-
Transportation Fund	6,082,388	-
Refuse Fund	291,116	
Internal Service Fund:		
General Fund	-	1,615,390
Enterprise Funds:		
General Fund	-	10,454,122
	<u>\$ 12,069,512</u>	<u>\$ 12,069,512</u>

The City allocates interest between the General and enterprise funds based upon month-end interfund balances at the average monthly interest rate of the state's local government investment pool. Such allocation for the year ended June 30, 2005 is reported as an interfund credit in the General Fund and as a portion of the administrative charge from General Fund in the enterprise funds.

Transfers between other funds and the general fund consist of the following at June 30, 2005:

	<u>Transfers In</u>	<u>Transfers Out</u>
General Fund:		
Capital Projects Fund	\$ -	\$ 884,000
Capital Projects Fund:		
General Fund	884,000	-
	<u>\$ 884,000</u>	<u>\$ 884,000</u>

The City transferred \$884,000 from the General Fund to the Capital Projects Fund to support “pay-as-you-go” funding for various capital projects.

(11) Contingencies

The City, in the normal course of activities, is a defendant in several lawsuits. Losses, if any, are estimated to be less than the City’s insurance coverage. Potential liabilities are covered by the City’s self-insurance fund and the City’s participation in the Maryland Local Government Insurance Trust, a public entity risk pool.

(12) Capital Facilities and Connection Charges

In the enterprise funds, capital facility charges are assessed to property owners over a period of thirty

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(12) Capital Facilities and Connection Charges, Continued

years from the date related properties physically connect to the City's water and/or sanitary sewage collection and treatment systems. Such charges are legally restricted to pay for capital construction within the systems or to pay for debt service on debt issued to finance such construction. As such construction is typically financed with debt, the City recognizes the annual charges earned as an addition to contributed capital. Charges levied and receivable in future years are reported as a receivable and deferred revenue.

A connection charge not exceeding the cost of connecting to the systems is assessed and collected prior to connection. Such revenue is recognized as operating income and recorded as charges for services.

(13) Construction Commitments

As of June 30, 2005, the City had \$9,062,000 in construction commitments. Road construction commitments amounted to \$1,161,000, public safety building improvements totaled \$6,093,000, recreation projects totaled \$492,000, water and sewer utility commitments were \$569,000 and the balance was in miscellaneous general government projects.

(14) Grants

The City receives grants from time-to-time. Expenditures from certain grants are subject to audit by the grantor, and the City is contingently liable to refund amounts received in excess of allowable expenditures. In the opinion of the City's management, no material refunds will be required as a result of disallowed expenditures.

(15) Risk Management

The City is exposed to various risks of loss related to torts; thefts of, damage to, and destruction of assets; errors and omissions; injuries to workers; and natural disasters. The City maintains a self-insurance fund and participates in the Maryland Local Government Insurance Trust, a public entity risk pool, which provides insurance for claims in excess of coverage provided by the City's self-insurance fund.

This is a total risk and cost sharing pool for all participants. In the event that the Trust's General Fund falls into a deficit that cannot be satisfied by transfers from the Trust's capital and surplus accounts, the Trustees shall determine a method to fund the deficit. The Trust agreement empowers the Trustees to assess an additional premium to each deficit-year participant. Debt issues could also be used to fund a deficit.

Premiums are charged to the City's General Fund, with no provision made for claim liability in addition to premiums, unless an assessment is made by the Trust. There have been no assessments during the year ended June 30, 2005.

The City accounts for the financial operations of the self-insurance fund in the Internal Service Fund. The City maintains excess coverage to reduce the exposure from catastrophic claims. A third party insurance administrator is employed to estimate funding requirements and liabilities of the self-insurance fund. The funding for each year represents the present value of the amount needed to pay the expected final settlement values for all claims which occur in that year regardless of the date

CITY OF ANNAPOLIS, MARYLAND

Notes to Basic Financial Statements, Continued

(15) Risk Management, Continued

reported. Claims "incurred but not reported" are accounted for as self insurance costs on the government wide statement of net assets. The carrying amount of liabilities for unpaid claims is presented at present value using a discount rate of 4% to recognize the time value of money. The changes in accrued payables and other liabilities during fiscal years 2005 and 2004 were as follows:

	<u>FY 2005</u>	<u>FY 2004</u>
Beginning accrued payables and other liabilities	\$1,270,951	\$238,562
Incurred claims and changes in estimates	668,819	1,296,868
Claim payments	(609,139)	(264,479)
Ending accrued payables and other liabilities	<u>\$1,330,631</u>	<u>\$1,270,951</u>

There have been no reductions in insurance coverage from the prior year and during the last three years the total amount of settlements has not exceeded insurance coverage.

(16) Landfill Closure

In accordance with the Maryland Department of the Environment regulations, as of June 30, 1993, the City's landfill operations were terminated. As of March 31, 1998, the landfill is closed with closure and postclosure costs recorded under current Federal and State regulations. The City will continue the monitoring process per the regulations and currently plans to maintain the site as open space. Actual costs may be higher due to inflation, changes in technology, or changes in regulations. An annual appropriation is established for the monitoring costs and any postclosure care requirements exceeding the original estimates will be covered by future tax revenues.

(17) Subsequent Events

On August 1, 2005, the City issued \$15,000,000 of general obligation bonds for improvements to various City buildings, garages, roadways, and utility infrastructure. The bonds have an interest rate range of 3.5% to 4.125% and the maturity date is August 1, 2025.

(18) Restatement of 2004

The City has restated the accompanying statement of net assets as of June 30, 2004 to accrue a liability for the incurred but not reported self insurance claims. The incurred but not reported claims liability had been presented as a designation of fund balance.